

Financial markets: short selling and certain aspects of credit default swaps

2010/0251(COD) - 15/09/2010 - Legislative proposal

PURPOSE: to establish a common framework concerning requirements and powers in relation to short selling and credit default swaps.

PROPOSED ACT: European Parliament and Council Regulation.

BACKGROUND: short selling of securities is a practice where a natural or legal person sells a security he does not own with the intention of buying back an identical security at a later point in time. It is an established and common practice in most financial markets. Short selling can be divided into two types: covered short selling where the seller has borrowed the security, or made arrangements to ensure they can be borrowed before the short sale and uncovered or naked short selling (where at the time of the short sale the seller has not borrowed the securities or ensured they can be borrowed).

At the height of the financial crisis, in September 2008, competent authorities in several EU Member States and the USA adopted emergency measures to restrict or ban short selling in some or all securities. The measures adopted by Member States were divergent as the European Union lacks a specific legislative framework for dealing with short selling issues.

Earlier this year concerns were expressed by some Member States about the possible role played by derivative transactions, notably credit default swaps, in relation to the prices for Greek sovereign bonds. A number of Member States (notably Germany and Greece) have recently adopted temporary or permanent restrictions at national level relating to short selling of shares and/or credit default swaps.

The **current fragmented approach to short selling and credit default swaps** limits the effectiveness of supervision and the measures imposed and results in regulatory arbitrage. It may also create confusion in markets and costs and difficulties for market participants.

In its [communication of 2 June 2010](#) on Regulating Financial Services for Sustainable Growth, the Commission considered that it would be desirable to **have a regulation** addressing the potential risks arising from short selling. The intention is to i) harmonise requirements relating to short selling across the European Union, ii) harmonise the powers that regulators may use in exceptional situations where there is a serious threat to financial stability or market confidence and iii) ensure greater co-ordination and consistency between Member States in such situations.

IMPACT ASSESSMENT: the Commission undertook an impact assessment of policy alternatives. Policy options related to the scope of the proposals, the proposed transparency regimes, requirements relating to uncovered short selling, exemptions and exceptional powers to restrict short selling.

LEGAL BASE: **Article 114** of the Treaty on the Functioning of the European Union (TFEU). Although all the problems outlined above have important implications for each individual Member State, their overall impact can only be fully perceived in a cross-border context.

CONTENT: the proposal covers **all financial instruments** but provides for a proportionate response to the risks that that short selling of different instruments may represent. Its main features are as follows:

Transparency requirements for short positions in certain instruments: for instruments such as shares and derivatives relating to shares, sovereign bonds and derivatives relating to sovereign bonds and credit default swaps relating to sovereign issuers where taking short positions is more common and there are clearly identifiable risks or concerns, transparency requirements and requirements relating to uncovered short selling are applied.

For companies that have shares admitted to trading on a trading venue in the Union, the proposal provides for a two tier model for transparency of significant net short positions in shares. At a lower threshold **notification of a position must be made privately to the regulator** and at a higher threshold positions must be **disclosed to the market**.

As regards significant net short positions relating to sovereign debt issuers in the EU, private disclosure to regulators is required.

The proposal includes a **requirement for the marking of short orders**. A requirement for the marking or flagging of sell orders executed on trading venues as short orders where the seller is entering into a short sale of shares on that venue will provide additional information about volumes of short sales executed on the trading venue. A trading venue will be required to publish daily information about volumes of short sales executed on the venue that is obtained from the marking of orders.

Uncovered short sales: uncovered or naked short selling of shares and sovereign debt is sometimes viewed as increasing the potential risk of settlement failure and market volatility. The proposals include detailed requirements aimed at addressing these risks.

To this end, natural or legal persons entering into short sales of such instruments must at the time of the sale have borrowed the instruments, entered into an agreement to borrow the shares or made other arrangements which ensure that the security can be borrowed so that settlement can be effected when it is due.

Furthermore, trading venues must ensure that there are adequate arrangements in place for buy-in of shares or sovereign debt where there is a failure to settle a transaction. Trading venues will have the power to prohibit a natural or legal person who failed to settle to enter into further short sales.

Exemptions: provisions are made for exemptions – for example, for shares of a company where the principal market for the shares is outside the European Union and for market making activities which play a crucial role in providing liquidity to European markets.

Intervention powers: in exceptional situations which constitute a serious threat to financial stability or to market confidence, competent authorities should have temporary powers to require further transparency or to impose restrictions on short selling and credit default swap transactions or limit natural and legal persons from entering into derivative transactions.

Where an adverse development or event creates a threat to financial stability or market confidence that extends beyond one Member State or has other cross border implications, the proposal introduces various procedural requirements aimed at ensuring that other competent authorities are notified if a competent authority intends to take exceptional measures related to short selling. The European Securities Market Authority ([ESMA](#)) is given a key coordination role in such a situation to try to ensure consistency between competent authorities.

Powers and sanctions: the proposal gives competent authorities all the powers necessary for the enforcement of the rules. For example, the powers cover access to documents, the right to obtain information from natural or legal persons and to take enforcement action.

BUDGETARY IMPLICATION: the proposal has no implication for the EU budget.